COMMENTS ON THE 2008 PROCUREMENT PROCESS PURSUANT TO SECTION 16-111.5(o) OF THE PUBLIC UTILITIES ACT

PRESENTED TO

THE ILLINOIS COMMERCE COMMISSION

by

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I. INTRODUCTION

Boston Pacific Company, Inc. appreciates the opportunity to submit these comments in response to the Illinois Commerce Commission's (the "Commission's") request for comments.

Boston Pacific served as the Procurement Monitor for all five of the requests for proposals (RFPs) issued by ComEd and Ameren in 2008.[1] As required by the Illinois Power Agency Act (the "Act"), Boston Pacific monitored all aspects of the development and implementation of the RFPs with emphasis on assessing bidder behavior for anticompetitive actions and assessing compliance with RFP rules. Our work included monitoring and providing expert advice on the (a) communication between parties, (b) development of and comments on both standardized contracts and credit policies, (c) bid evaluation methodology and software, and (d) calculation and use of market-based price benchmarks.

Also as required by the Act, within two days of the conclusion of each RFP, we provided a confidential report to the Commission. In all cases we recommended that the Commission accept the results of the 2008 RFPs. In general, the basis for our recommendation was that the RFP achieved its stated objectives, there was no evidence of collusive or otherwise anticompetitive behavior, and the rules for the RFP, as specified by the Act and approved by the Commission, were followed.

In these brief comments we make a few recommendations on the topics that might be addressed in preparation for the 2009 procurement process.

II. ASSESSING BIDDER BEHAVOIR FOR ANTICOMPETITIVE ACTIONS

A. Fairness and Transparency

It is best to prevent collusive or otherwise anticompetitive behavior, rather than to detect and punish it. The best prevention is to attract a large number of qualified bidders. With a large number of bidders it would be difficult to arrange and hold together a collusive scheme, and it would be difficult for one party to dominate and push prices upward.

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[1] By way of background, Boston Pacific is a consulting firm, located in Washington, DC, which specializes in the electricity and natural gas businesses. We have extensive hands-on experience monitoring most of the major full requirements solicitations in the country, including our engagements for (a) New Jersey's 2007 and 2008 Basic Generation Service Auctions, (b) the 2005 through 2008 Standard Offer Service (SOS) RFPs for the District of Columbia, (c) Delaware's 2006 and 2007 SOS RFPs, (d) Maryland's SOS RFPs in 2004, 2005 and 2006 for all four utilities, and (e) the 2006 Illinois Auction. We have monitored or are currently monitoring over 70,000 MW of full requirements procurements in total. Additionally, we design and monitor unit-contingent procurement processes, which solicit bids for long-term contracts from individual power plants and other resources; examples include our current engagements in Oregon, Oklahoma, and the Virgin Islands. Boston Pacific also has served since 2004 as the Independent Market Monitor/External Market Advisor for the Southwest Power Pool Regional Transmission Organization.

The best way to attract a large number of qualified bidders is to design and implement a fair and transparent RFP; that is, an RFP which suppliers see as a fair chance to win or lose. The three most important ingredients for such an RFP are (a) a well defined product – everyone knows what they are required to provide, (b) a standard contract in which all non-price requirements are set – there is no discretion on hard-to-measure non-price factors to influence who wins or loses, and (c) since all non-price requirements are set, a price-only bid evaluation – this is the ultimate in transparency.

The designs of all five RFPs were fair and transparent in this sense. The result was that all five RFPs were reasonably competitive in terms of the number of bidders. A total of 21 different bidders won rights to a contract under the five RFPs; 15 won in the three RFPs for energy or capacity, 9 won in the two RFPs for Renewable Energy Credits (RECs), and there were 3 who won in both sets of RFPs. As a point of comparison, for the residential and small commercial customers in the 2006 Auction there were 15 winning bidders.

Promotion and publicity for RFPs is another way to attract a large number of bidders. We recommend that direct outreach, such as that used in the ComEd RFP for RECs, becomes the standard; potential bidders for each product should be focused on as distinct groups. More broadly, we recommend that the Procurement Administrator be required to submit a promotion and publicity plan for review by the Procurement Monitor. (Developing this plan should be an explicit part of the scope of work for the Procurement Administrator.)

B. Market-based Price Benchmarks

Behavior also was assessed, as required by the Act, by comparison of (a) the winning bid prices to (b) market-based price benchmarks. Boston Pacific strongly supports the use of such benchmarks. They provide information that the Commission can use to judge whether the winning bid prices in the Illinois RFPs are consistent with broader market prices. And, in this sense, they allow the Commission to judge whether prices are the result of broader market forces. We endorse the benchmarks used in 2008. However, this was the first experience using benchmarks of this type to potentially limit bid consideration and the implementation deserves further attention.

III. ASSESSING COMPLIANCE WITH RFP RULES

A. Product Definition and Procurement Design

Illinois has conducted two important procurements, both fundamentally sound, with two very different product definitions and RFP designs. For the 2006 Auction, the product was full requirements service for three different lengths of contracts – one, two, and three years. For the 2008 RFPs, the two products for ComEd's RFPs were physically delivered blocks of energy, and RECs; Ameren solicited offers for price guarantees (financial swaps) for blocks of energy, blocks of capacity, and RECs. The contracts in the 2008 RFPs all have one year terms.

There is no one right approach to product definition or procurement design. However, each approach has important implications that should be reassessed over time. The most important implication of product definition is who bears what risks. With a full requirements product, the winning bidders shoulder a great deal of risk, instead of that risk being shouldered by ratepayers. These winning bidders agree to supply all elements of the service needed by a ratepayer – block energy, dispatchable energy, capacity, ancillary services, and actions to meet renewable portfolio standard requirements (if any). They agree to provide this full requirements service at a fixed price for the term of the contract. Suppliers also agree to take on market risk; they guarantee to serve a percentage share of a customer class's need regardless of how many or how few of those customers choose an alternative supplier.

With procurement for blocks of energy, the supplier agrees to provide just blocks of energy at fixed prices. At any particular time, since customers do not use electricity in nicely defined blocks, those blocks may provide too much or too little energy to serve customers' needs. For this reason, some of the block energy may have to be sold in the PJM spot market at some times, and more energy must be purchased in the PJM spot market at other times. Ratepayers shoulder the risk of the purchase and sale of this dispatchable energy – that is, there is no guarantee on price or quantity. Similarly, for ComEd at least, the ratepayers have taken on the risk of paying for capacity through PJM's new Reliability Pricing Model (RPM) and for ancillary services through the broader PJM markets. And ratepayers, not the supplier, take on market risk.

The Act requires a risk assessment as part of the Procurement Plan.[2] We simply want to emphasize the importance of that risk assessment to product definition. At a minimum, to determine the full price to ratepayers of the 2008 RFPs, the costs of purchases in the PJM markets must be tallied as the year goes on and added to the prices paid for block energy and capacity. We also recommend a broader assessment that includes (a) an identification of the risks taken on by ratepayers with each product definition, and (b) an estimation of the risk premium paid for the product with suppliers taking on more risks.[3] In that same context we suggest an assessment of the best term lengths for contracts.

For the 2006 Auction, the procurement design was multiple round, uniform winning price. For the 2008 RFPs, the procurement design was single round, pay-as-bid.[4] In professional literature and in real-world practice, the evidence on which procurement design is best for ratepayers is surely mixed. However, these back-to-back procurements in Illinois provide an ideal opportunity to assess procurement design for the long run.

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[2] Act, Section 16-111.5(b)(3)

[3] Such an estimation would have to take account of changes in market conditions between 2006 and 2008. For example, the winning prices for the 17-month full requirements product in the 2006 Auction were $63.96/MWh and $64.77/MWh, respectively, for ComEd and Ameren. In the 2008 RFPs, prices for just 12-month block energy were, respectively, $67.49/MWh and $68.43 MWh for ComEd and Ameren (assuming all need was met and adjusted for the number of blocks of each product and the number of hours in each month). The fact that 2008 RFP prices for block energy were higher than 2006 Auction prices for full requirements service means market conditions pushed prices up; the effect of market conditions should be isolated in the estimation.

[4] Act, Section 16-111.5(e)(4): "sealed, binding commitment bidding with pay-as-bid settlement, and provision for selection of bids on the basis of price."

B. REC Priorities

The Act sets priorities for the purchase of RECs. The top priority is to procure the number of RECs needed to meet the Renewable Portfolio Standard (RPS) at no more than the dollar budget set by the Act. If this top priority is met, and the budget has not been exceeded, then the next priority is that 75% of the RECs be from wind resources. If the wind priority is met and the budget has not been exceeded, then there are locational priorities; that is, a preference is set for Illinois RECs and for Adjoining State RECs.

The priorities reflect policy goals such as the promotion of Illinois renewable energy development. As expected, the priorities mean that the cost of RECs are higher than if there were no priorities. That is, the RECs cost more because of the wind preference and, more importantly, the locational preferences. We recommend that, going forward, a clear record is kept of the costs of achieving these priorities and of whether the policy goals are actually achieved. In addition, we recommend that the competitive effects of the priorities be assessed.

C. Standard Contracts

Both Procurement Administrators used variants of industry standard contracts to develop standard form contracts for the specific products in each RFP. This is not only an acceptable method of meeting the Act's requirement that contracts "meet generally accepted industry practices,"[5] but also serves to make the process more welcoming for bidders, many of whom may be used to dealing with these industry standard contracts.

This was a generally successful method, as evidenced by the results of each RFP. One of the reasons for this success was the attention paid to reviewing bidder comments on draft contracts. This review created an obvious tension between entertaining individual comments, to entice bidders to make competitive bids, and designing a one-size-fits-all contract for transparency. However, at the conclusion of comment review, the finished contracts were well thought out, and had been thoroughly vetted by bidders, the utility, the Procurement Administrator, the Procurement Monitor, and Commission Staff.

The contracts that were used in the 2008 RFPs are thus a good foundation for future years. However, it will always remain worthwhile to carefully consider whether the contracts meet the changing needs of both bidders and the utilities, and to solicit and take seriously bidder comments.

Finally, in this context, three additional points on the REC RFPs should be made. First, some flexibility on delivery period was allowed with the expectation it would lower prices. However, this might increase the chance of default; incidents of default should be tallied through the full year. Second, verification of RECs through tracking systems is sufficient; no additional verification by the Procurement Administrator seems necessary. Third, the REC priorities make winning REC prices unique to these RFPs. Prices revealed from one RFP can significantly affect

[5] Act, Section 16-111.5(e)(2)

prices offered in a subsequent RFP, so some thought should be given to when and how REC RFPs are held and results are made public. One approach to consider is to hold a single state-wide REC RFP, but the full implications of this approach have to be thought through.

D. Credit Requirements

Boston Pacific carefully considered the exact nature of the credit requirements proposed by the utilities and the Procurement Administrator. Credit requirements are important in a procurement because they provide collateral for ratepayers in the event of a bidder default. However, credit required special attention in these RFPs because of the on-going credit crisis in the U.S. Broader credit market developments should always be considered when making specific credit requirement decisions because these developments impact the costs of credit requirements for bidders, who then may pass on such costs to ratepayers through higher bids.

The bid security and collateral requirement approach to credit taken in these RFPs was constructive. We believe that the credit policies significantly limited ratepayer risk at a reasonable cost. We also note that the utilities offered reciprocal credit to bidders in most of these RFPs. Collateral has typically been something only bidders have to post, but it was constructive because it may have had the benefit of lowering bidders' risk, leading to lower bid prices (we understand the offer of reciprocal credit was in response to the ratings downgrades of the two utilities, downgrades which came in the wake of the Illinois Legislature's consideration of a rate freeze). At the same time, we recognize there is a cost to providing reciprocal credit, and, going forward, that the balance of these costs and benefits will be weighed. Consideration also should be given to who is best able to mitigate this risk.

Beyond recommending an updated assessment of credit requirements for the 2009 RFPs, Boston Pacific would suggest one change in the credit process. Financial disclosure requirements for each bidder should be stated more clearly to ensure that each bidders' credit worthiness (e.g. in the calculation of a collateral threshold) is calculated in the exact same manner. This could be done by requiring the most recent 10-Q from all bidders, or information that is substantially the same and is as timely.

We also add that, in future years, attention should be focused on credit requirements because of the possibility for contracts longer than one year. The longer the contract term, the more impact credit specifications will have on the risks ratepayers shoulder and on the costs to bidders – and thus, the price paid by ratepayers.

E. Preparation for Bid Day

Preparation for bid day is essential to ensure that each RFP is transparent, to draw in as many bidders as possible, and to ensure that each bid day runs smoothly. That is why the Procurement Administrators did a great deal of preparation and bidder education for each RFP. Boston Pacific either monitored or participated in each phase of this preparation. We attended bidder sessions in which the RFP, contracts, and bid documents and bid submission procedures were discussed. We participated with the Procurement Administrators in dry runs of bid day, to

test the bid submission process as well as the bid evaluation methodology and all software involved.

In sports, coaches often say that "you win on the practice field." Similarly, with each Illinois procurement RFP, our experience shows that the ratepayer wins when all parties prepare for bid day. That is why it is essential that this same preparation, or something substantially the same, occurs before each RFP in 2009 and in all future years as well.

All this preparatory work is crucial to attract bidder interest in the RFPs, to help bidders understand the RFP, and to ensure that many bidders cross the finish line of bid submission. One additional way to draw in more bidders may be further standardization of the RFP process and documents. Each utility has the right and obligation to develop and use a process and documents that fit its unique circumstances. However, some standardization could attract more bidders. For example, having a single Procurement Administrator might help to standardize the contracts and the qualification process. This would make the Procurement Administrator selection process even more important.

F. Bid Day

Bid day is the culmination of a RFP. The successful conclusions of each of the five 2008 RFPs prove that each bid day was well run. Part of a well-run bid day, and necessary for the transparency of the entire process, is monitoring by the Procurement Monitor of bid receipt and of any questions that may arise and that may need to be quickly answered.

To facilitate this monitoring, the window for bid submission should be limited to one day, with well-defined opening and closing times. A single bid day allows the Procurement Monitor to be present when each bid is received by the Procurement Administrator, ensuring that bids are evaluated in the same form in which they were received and that any questions or concerns that arise are handled in accordance with the rules.

Also, bid day might be structured to support the use of benchmarks by closing at the same time that the relevant markets close. This allows the benchmark to be calculated using the most up to date data, and substantially the same data that bidders were likely to have used when creating their bid prices.

G. Illinois Energy Investment

Finally, separate from the RFP process, we would suggest that an additional major issue be monitored: whether investments in generation, transmission, energy efficiency, demand response, renewable energy, and other new technologies are adequate to serve Illinois's future electricity needs and to do so with a diverse portfolio of resources, which mitigates risks. This is the ultimate, long-term test of whether the RFPs are doing their job.